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I would like to thank Chairman Tanoue for holding this forum to examine some key issues related to the Federal Deposit Insurance Corporation (FDIC). I'm pleased to represent the American Bankers Association (ABA) today. The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership - which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks - makes ABA the largest banking trade association in the country.

Assuring that the FDIC's deposit insurance funds remain strong is of the utmost importance to the banking industry. Over the past decade, commercial banks and savings associations have gone to extraordinary lengths to rebuild the insurance funds, contributing $36.5 billion to ensure that the insurance funds are well capitalized. With the Bank Insurance Fund (BIF) at $29.6 billion at the end of last year and the Savings Association Insurance Fund (SAIF) at $10.3 billion, both FDIC funds are extremely healthy. In fact, few commercial companies' net worth is as large as the combined net worth - $40 billion - of the FDIC's insurance funds. For example, if the FDIC were a commercial bank, it would rank third in book-value capitalization!

The outlook is also excellent. There have been few failures, and the interest income earned by BIF and SAIF (about $2.3 billion per year) easily exceeds the FDIC's cost of operation. As interest income continues to exceed expenses, the BIF and SAIF are likely to continue to grow further beyond the designated reserve ratio mandated by Congress. The strength of the FDIC funds is further protected by strong laws and regulations including prompt corrective action, least cost resolution, risk-based capital, risk-based premiums, depositor preference, regular exams and audits, enhanced enforcement powers and civil money penalties. Taken together, these provisions should reduce the number of bank failures, lower the costs of those that do fail, and ensure that the FDIC will have more than adequate resources to cover any contingency.

With the deposit insurance funds so strong, now is the perfect time to consider how we might improve the overall system. I think we all agree that waiting for a problem to develop before changes are made are not appropriate. Your analogy, Chairman Tanoue, that it's better to fix the roof on a sunny day than to do it when it's raining hits the mark perfectly.

In mid-February, ABA testified before Congress that a comprehensive approach to deposit insurance reform is needed, and that simply merging the deposit insurance funds is not a sufficient response to the many issues that need to be addressed. We are pleased, Chairman Tanoue, that the FDIC is looking at all the elements and not just at merging the deposit insurance funds. This

forum, and the regional meetings that are scheduled, is an excellent way to air the issues and receive input from the industry.

The ABA has been working to develop an industry consensus – a requirement for any legislation to be enacted. To that end, we have held extensive discussions with both commercial banks and savings institutions (during our Washington Visits program, Spring Bankers Summit meeting, and town meetings across the country), worked with our state association partners to survey banks about their concerns and priorities for deposit insurance reform, and met with members of Congress – all with the goal of developing an approach that could be acceptable to a broad range of parties.

These are not easy issues, particularly given the history of these issues and the controversy surrounding them. History tells us that Congress is unlikely to adopt significant deposit insurance changes (except if there is an emergency) unless the banking industry presents a united approach on what needs to be done. That is what ABA is trying to accomplish through its consensus-building process. While we have a few more weeks to hear from the states, the trend is already very clear. We are hearing strong support for a comprehensive approach, and we are hearing strong support for three major elements of such an approach. In addition, there are several other issues that clearly will need to be addressed.

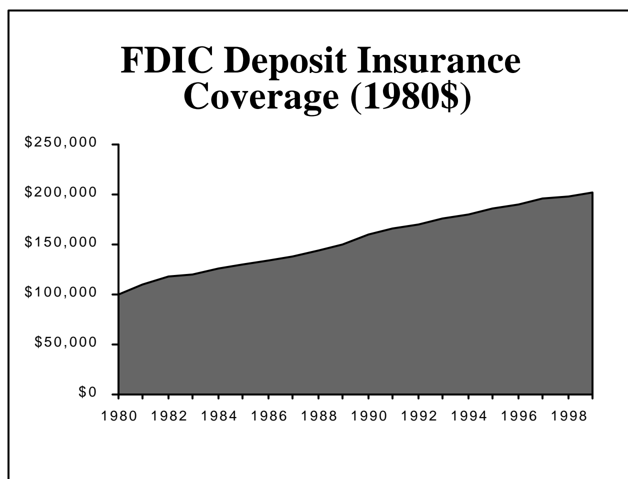
The three most important areas to be addressed that are emerging so far from our discussions, and should form the heart of any comprehensive plan, include:

- Adjusting the insurance limit of $100,000 upward in recognition of the decline since 1980 in the real value of the insurance level;
- Permanently indexing the insurance limit to account for the future effects of inflation; and
- Capping the insurance funds and providing rebates.

The ABA could only support a merger of the insurance funds if these elements have been adequately addressed.

Insurance Level Should Account for Inflation

In our extensive discussions, one issue of particular concern is the current coverage level of $100,000 for deposit insurance. This level was set in 1980. On an inflation-adjusted basis, this current level is close to the $40,000 level that was in effect prior to the 1980 change. Thus, essentially, inflation has cut the real value of deposit insurance by over half in the last two decades. As a consequence, on the margin, it is more difficult, particularly for smaller institutions, to raise sufficient amounts of funds to meet loan demand in



their communities. The ABA believes that an adjustment needs to be made to reflect the loss of real value of this limit. To restore the "purchasing power" of the 1980 level would require a doubling of the current limit.

The Insurance Level Should Be Permanently Indexed

In addition to adjusting the level to reflect past declines in the real value of coverage, it is also important that the level be permanently indexed so that depositors can rest assured that their protection not be eaten away by inflation in the future. This is not an issue that should be subject to Congressional review time and time again, but needs to be resolved permanently.

The Size of the Insurance Fund Should Be Limited

The ABA believes strongly that there should be a limit to the size of the FDIC insurance fund and rebates provided. Not only are the BIF and SAIF currently fully capitalized, they are $4 billion over the designated reserve ratio (DRR) set by Congress following the difficulties in the 1980s. Moreover, with interest income exceeding the FDIC's operating expense by about $1.5 billion a year, it is highly likely that the funds will continue to grow. The compounding effect of an ever-increasing fund will mean even greater rates of growth in the future.

The amounts in excess of the DRR are not necessary to ensure the soundness of the deposit insurance system; however, they do represent a significant loss of potential investment by banks in the communities they serve. I can tell you as a banker, I certainly can put rebates to good use in my community providing loans and services to my customers. This will have a far greater positive impact on economic conditions in Clinton, Missouri than if that money sits in the government's coffers in Washington.

Will limiting the size of the fund by setting a maximum reserve ratio and providing for rebates when the fund exceeds the maximum affect the ability of the FDIC to meet its financial obligations? The answer is no. I firmly believe that the flexibility already vested with the FDIC to adjust funding levels, combined with the significant regulatory powers set in law and regulation, are more than sufficient for the FDIC to meet any funding contingency. But even more important is that the banking industry has an unfailing obligation - set in law - to meet the financial needs of the insurance fund. Simply put, limiting the size of the fund and expanding the rebate authority will not affect the FDIC's ability to meet any future obligations to insured depositors.

We recognize that increasing the insurance level will affect the fund's ratios and thereby delay the date the funds reach any cap. However, we believe it is very important that the cap be in place.

Importantly, there already is a precedent for capping and providing rebates of excess funds beyond a fixed reserve ratio. The National Credit Union Share Insurance Fund (NCUSIF) has the authority to rebate funds that exceed the "normal operating level." The National Credit Union Board must set annually the target operating level above which rebates are provided. For the last five years, NCUSIF has rebated back to the credit unions millions of dollars to keep the fund level between

1.25 percent and 1.30 percent of insured share deposits. ***In fact, over the last 5 years, NCUSIF has rebated over $500 million to credit unions.*** For 2000, the normal operating level has been set at 1.30 percent; thus rebates will be provided to maintain the fund at that level.

Importantly, the normal operating level set by NCUSIF cannot exceed 1.50 percent of insured share deposits. This sets a mandatory cap on the size of the fund. It is worth repeating, however, that the NCUSIF has set the level at 1.30 percent and will provide rebates to maintain it there, rather than waiting for the fund to reach its maximum level.

We believe that all federal deposit insurance funds should have rebate authority. We see no justification for disparate treatment between the credit union and bank and savings institutions insurance funds.

The ABA strongly supports bills introduced by Congressmen Lucas (R-OK) and Watt (D-NC), H.R. 4082, and Senators Santorum (R-PA) and Edwards (D-NC), S. 2293, which address the rebate issue. These bills raise the interesting concept of using rebates to offset the FICO obligation imposed on the banking industry.

Additional Key Issues For Bankers

From what we are hearing in our consensus building process, there are several other areas of concern that will need to be addressed as part of a comprehensive approach. For example, treatment of municipal deposits is one area where there is considerable concern and discussion. The ABA has formed a task force of community bankers to review the issues and suggest options for reform, including changing pledging requirements, limiting solicitation for municipal deposits to local financial institutions, and increasing insurance coverage.

Bankers have raised concerns about the fact that new deposits coming into the BIF and SAIF do so without any premiums being paid. This issue also applies to net new deposits flowing into banks and from *de novo* banks. Bankers have raised questions including whether there should be some formula for paying premiums, possibly through adjustments to the risk-based structure, on net new deposits (at least on large net new deposits), and whether rebates, if enacted, should be paid on the basis of previous premium payments.

Throughout the last decade, there has been debate on whether it is appropriate to combine the OTS and the OCC. Such a combination was favored a few years ago in the context of a combined, and enhanced, bank and savings institution charter. Legislative changes, of course, have altered the importance of such a change. We are finding in our survey process that many of our members are not wedded to the previously held position that OTS and OCC should be combined. In addition, it is clear that this issue is controversial within the broad banking industry. Therefore, in an effort to develop a consensus that can have broad industry support and maximize the chances for enactment, ABA plans to reconsider at our May 25 Board meeting whether or not the OTS-OCC combination needs to remain part of ABA's definition of a comprehensive approach.

Several other issues have also been raised that should be mentioned. The first is that many bankers believe that the $30 billion line of credit from the Treasury to the FDIC is unnecessary and continues the misperception that government support is necessary to maintain the integrity of the FDIC funds. Such a line of credit is unnecessary since the ***banking industry has an unfailing obligation – set in law – to meet the financial needs of the insurance fund.*** Simply put, the industry's capital base stands behind the FDIC fund.

Bankers also continue to be concerned that the "too-big-to-fail" doctrine remains in place. The ABA articulated a firm position nearly a decade ago in a report of our Deposit Insurance Task Force that no bank should be too-big-to-fail. Since that time, ABA has actively supported legislation to eliminate this doctrine. We believe that once again this issue needs to be discussed.

Conclusion

In conclusion, Chairman Tanoue, we appreciate your interest in examining the deposit insurance system from top to bottom. A comprehensive approach is simply the best approach. Adjusting the coverage level and permanently indexing the deposit insurance funds are important issues that need to be addressed.

The passage of FDICIA in 1991 marked a sea change in how the deposit insurance system is funded. Prior to FDICIA, the FDIC had very limited authority to quickly raise funds from insured depository institutions. In this circumstance, safety was almost completely dependent on building a huge reserve, regardless of the current condition of the industry. Prudence became synonymous with a growing level of reserves – the bigger the better.

FDICIA, however, made fundamental changes in how the system operates. Today, the FDIC has a wide array of regulatory tools with which to minimize the number and cost of failure resolutions. Equally important, FDICIA gave the FDIC the authority to quickly build the fund's resources in the event of trouble. But without some limit on the size of BIF and SAIF and some way to rebate excess reserves to member institutions, we are continuing to cling to the pre-FDICIA concept that we must have a huge and growing fund. Not only is this continued allegiance to the "no-fund-is-too-big" theory unnecessary in the post-FDICIA world, but it is very expensive.

Chairman Tanoue, we are prepared to work with you and your staff to find the best solution for these critical issues.

Appendix A

The Size of the Insurance Fund Should Be Limited

Capping the insurance fund and providing rebates will not limit the FDIC's ability to meet any contingency.

Reserves for Future Losses
FDIC has great flexibility to adjust reserves for future losses. If the FDIC anticipates greater losses from failures, it simply allocates more resources (either out of current income or from capital) to this reserve. As provisions are added, the reserve ratio declines. The FDIC has complete flexibility to raise the level of reserves for losses if it foresees higher losses. And the FDIC is obligated to charge higher insurance premiums if the reserve ratio falls below the DRR.

There are two very important points here. First, the reserve ratio does not represent the FDIC's only resources available to resolve failures and meet operating expenses. Second - and most important to the discussion of placing limits on the size of the fund - the FDIC can, to a great extent, control the level of the reserve ratio by adjusting the reserves it allocates for losses.

The history of the FDIC's reserve management provides a sobering lesson on how the ability to move funds among buckets works, and how powerful it can be. In reaction to the rising failures in the late 1980s, the FDIC added to reserves. By 1991, the FDIC had $16 billion in reserves for future losses, making the net worth of the funds appear to be negative. However, $13 billion of the $16 billion was never needed! In fact, one reason the BIF grew so rapidly (apart from the $5.5 billion average yearly premiums the industry was providing) was the recapture of these excess reserves for future losses back into the net worth of the funds. Current adjustments to this reserve only reinforce the powerful tool that the FDIC has at its disposal. The FDIC nearly doubled the reserve levels in the fourth quarter, and is likely to raise them again in the quarter that just ended.

Authority to Raise the Designated Reserve Ratio
The FDIC has the authority to raise the DRR if it can document that it is justified for that year "by circumstances raising a significant risk of substantial future losses to the fund." By raising the DRR, the FDIC would likely be raising the assessments necessary to maintain that new higher level. Thus, if the FDIC foresees problems, it has this additional authority to easily deal with the situation.

Risk-Based Premiums
Under this system - authorized in 1991 by Congress and implemented in 1993 - assessment rates dramatically increase if an institution's capital declines or if supervisory concerns increase. Thus, premium income to the FDIC rises automatically as individual institutions pose - and as the industry as a whole poses - greater risk of loss to the FDIC.

Today, of course, the banking industry is extremely healthy, with nearly 94 percent of the banks and savings institutions well-capitalized (25 percent above regulatory requirements) and of no supervisory concern. Since the insurance funds are well above the DRR, these institutions pay no

insurance premiums (although they do pay the FICO obligations). If deteriorating economic conditions lead to greater risks to the FDIC, the risk-based system provides an automatic increase in funding levels.

Recently, the FDIC has made additional changes to the risk-based system designed to identify patterns that signal future problems. This should serve to improve the sensitivity of the risk-based system to changes, and build in the automatic adjustments sooner than would otherwise have been the case.

Mandatory Recapitalization

If the reserve ratio falls below the DRR, the banking industry must immediately rebuild the fund back to the DRR. If the rebuilding is expected to take longer than one year, a mandatory recapitalization plan at very high assessment rates (minimum 23 basis points of domestic deposits) must be established. Thus, if the industry continues to grow, the practical impact is that the fund balance will never fall below 1.25 percent of insured deposits for any length of time. In dollar terms, the fund would therefore always be over $35 billion.

Additional Authorities that Protect FDIC

Beyond the flexibility to adjust the deposit insurance funds to meet any contingency, there are other important laws and regulations that have fundamentally changed the operating environment for FDIC. Taken together, these provisions lower the probability of banks failing and reduce the cost to the FDIC from those that do fail.

- Prompt Corrective Action: This established mandatory regulatory actions as capital levels fall below the minimum requirements.

- Critically Undercapitalized Institutions: This requires mandatory conservatorship or receivership of institutions with capital less than 2 percent. Theoretically, if receivership takes place, the FDIC should suffer no losses on the institution at all.

- Holding Company Guarantees/Cross Guarantees: This requires the holding company to guarantee compliance with recapitalization plans of the bank and puts losses on sister banking institutions of a holding company in the event that one bank subsidiary fails. By expanding the obligation to cover losses, the FDIC effectively reduces its loss exposure.

- Depositor Preference: This law elevates the FDIC's claim above general creditors (standing in place of the insured depositors that it has made whole) in the receivership of any failed bank. This superior claimant position will certainly lower resolution costs to the FDIC.

- Rules Restricting Too-Big-To-Fail: FDIC may not take any action, directly or indirectly, that causes a loss to the insurance fund by protecting depositors for more than the insured portion of deposits or by protecting creditors other than depositors.

- Emergency Special Assessment Authority: This authority requires the industry to repay any borrowing by FDIC and for any other purpose deemed necessary.

- "Least-Cost Rule": This requires the FDIC to resolve failures in the least costly manner of all alternatives.

- Line of Credit Expanded: The 1989 law increased the FDIC's line of credit to the Treasury from $5 billion to $30 billion and made it mandatory for the industry to repay any borrowing.

Simply put, limits on the size of the insurance fund and expanding the rebate authority poses no concern to the FDIC funds - existing laws and regulations provide the needed flexibility to meet any financial obligation that may arise.

Appendix B

Rebate Authority Should Be Expanded

Currently, the FDIC has limited rebate authority. It restricts the FDIC to refunding premium income (paid in the previous assessment period) from the top-rated institutions should it not be necessary to maintain the1.25 percent level. This authority - provided in 1996 - is very narrow and has not been used. This is because the fund is over-capitalized and thus the top-rated institutions pay no insurance premiums. This law recognizes, however, the importance of premium payments in maintaining the 1.25 percent DRR, and that it would only be interest income that would grow the fund beyond that point.

The issue today is whether the FDIC should have authority to rebate interest income which is continuing to build up the fund. We believe that authority should be explicitly provided to rebate funds above the 1.25 percent level and that there is a mandatory rebate above some fixed, higher level. The reason that BIF and SAIF are so strong is that commercial banks and savings institutions have paid almost $37 billion over the last decade in insurance premiums. While the industry willingly assumed this obligation, the opportunity costs of doing so were very large. The interest income on these funds should be considered to be dividends paid on this huge investment in the security of the FDIC. To do less only compounds the opportunity costs: not only were the original dollars paid in premiums to capitalize the funds not available for providing local financial services, but having the FDIC retain the interest income also prevents these dollars from being used to support local economies. As we have said time and time again, these excess funds could clearly be put to better use by banks in providing financial services to their communities.

Besides the fact some rebate authority already exists, there is also a precedent to rebate excess funds beyond a fixed reserve ratio. The National Credit Union Share Insurance Fund (NCUSIF) has the authority to rebate funds that exceed the "normal operating level." The National Credit Union Board must set annually the target operating level above which rebates are provided. For the last five years, NCUSIF has rebated back to the credit unions millions of dollars to keep the fund level between 1.25 percent and 1.30 percent of insured share deposits. In fact, over the last 5 years, NCUSIF has rebated over $500 million to credit unions. For 2000, the normal operating level has been set at 1.30 percent; thus rebates will be provided to maintain the fund at that level.

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